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ABOUT US

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Tax Implications On Reconstituion Of Partnership Firm

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ABSTRACT

There has been a never-ending saga on the disputes involving capital gains to be levied on the money/assets paid to the partners getting retired for a several years now. With an objective to bring some clarity, the government introduced Section 45(4) under the Income Tax Act, 1961.The said section provides that capital gains should be taxed in the hands of the specified entity.There are no accurate answers on the above issue and the courts have passed several judgements. The taxation on the exit of a partner was specifically excluded till financial year 1987-88.[1] In order to prevent misuse of the exemption, Section 45(4) was introduced by the Income Tax Act, 1961 in the year 1987.[2] The issue was very contentious and thus the legislature introduced some amendments which redesigned the entire scheme of taxation in case of reconstitution of a firm.

Key Words: Taxation, Reconstitution, Retirement, Finance Act, exemption, capital gains.

[1] The transaction was not considered as a transfer under Section 47(ii) of the Income Tax Act, 1961.

[2] Introduced in the Finance Bill of 1987.

INTRODUCTION

Taxation in case a Partners retires from a firm has been a contentious issue for a very long time. There have been various judgements on the issue and conflicting as well. For a very long time, there was no capital gains tax on distribution as assets on dissolution of partnership firm. As a result of which, individuals used to convert the assets of their firm into individual assets either upon dissolution or retirement contending that capital gains tax is not payable.

To overcome this tax planning exercise, the legislature introduced Section 45(4) which imposed capital gains in the hands of the partnership firm. However, the same resulted in a lotof litigation as a result of which there was an amendment under Section 45(4) to resolve the issues. Through Finance Act, 2021 the legislature redesigned the entire scheme through introduction of Section 9B. The article critically analyses the changes and some open issues. The legislature introduced Section 45(3) along with Section 45(4) to solve the misuse of provisions and deleted the erstwhile section 47(ii) to bring clarity.

The changed provisions starts with a non-obstante clause and thus, the provisions will overrideif there is anything contrary to the provision provided in the income tax Act. Through this amendment, the legislature has favored the view that on retirement of partner, there is a transferof right and thus capital gains tax should be levied with respect to the same. The new provisionshave clarified that revaluation of assets should not be included while computing gains.

RESEARCH QUESTIONS

1. Whether there is a transfer from the retiring partner to the continuing partners when a certain amount is paid to the retiring partner by the firm.
2. Whether there is a transfer of capital asset to the retiring partner by the firm when a certain asset is allocated to the retiring partner by such firm.
3. Whether there is a transfer of capital asset by a partner to the firm when the partner contributes a personal asset to the firm.

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ANALYSIS OF THE PROVISIONS THROUGH JUDICIAL DECISIONS

In the matter of **Mohanbhai Pamabhai[3],** it was held by the Gujarat High court that there doesnot exist any extinguishment by the retiring partner towards the continuing partners, hence there cannot be any transfer[4]. Even if there is a transfer, there is no consideration since the retiring partner is realizing his share in the net assets of the firm and thus such an amount is not consideration in lieu of the said transfer. The partner is just realizing his share and settling his rights. The said judgement was affirmed by the Supreme court.

In the matter of **Tribhuvandas G Patel[5],** it was held by the High court that the question whether a particular transaction upon retirement would result in releasing of interest in favourof continuing partners would depend upon the mode of retirement. If the retiring partner agreesto take lumpsum in consideration of relinquishing his share instead of taking his share on the basis of notion sale, the transaction would come within the ambit of transfer. Such a transactionwould be subjected to tax. The court came to this conclusion without analysing the facts of Gujarat High court's decision in *Mohanbhai's* case (supra).

So, until the above judgement by the Bombay High court, the view was that there would be no transfer when partners settle their rights. Since, in this case the partner was paid an amount in excess to his balance in the capital account and there existed a deed which extinguished his rights and claims towards the continuing partners , it was inferred by the Bombay High court that excess amount received was subject to tax. Further, it was pointed by the court that if the retiring partner assigns his interest by a deed then the transaction would be a transfer wherein the partner has stated that he has no further claims against the co-partners. It was further rejected by the court that dissolution and retirement are the same as pleaded by the assessee. The said judgement was reversed by the Supreme Court.

Thus, it is clear that there are two different views in relation to tax implications of amount received by the retiring partner.

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[3] Addl. CIT v. Mohanbhai Pamabhai (1987) 165 ITR 166 (SC)

[4] Section 2(47) of the Income Tax Act, 1961.

[5] CIT v. Tribhuvandas G. Patel, (1999) 236 ITR 515 (SC)

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In the matter of **Commissioner of Income Tax vs AN Naik Associated & Anr[6],** the phrase 'otherwise' was interpreted to cover retirement as against simple interpretation which covers only dissolution within it's ambit. It is pertinent to note that the court in this particular case considered whether asset allocation on retirement comes within the ambit of Section 45(4) andnot whether the said transaction amounts to transfer against the consideration received by the partner on the said retirement. Accordingly, the Bombay High court held that allocation of capital asset to the retiring partner is taxable in the hands of the firm. If the section were to beinterpreted to cover only 'dissolution' then the entire purpose of the provision goes into drain.The above judgement was subsequently upheld by **CIT v. Nathan and Co.[7]**

However, the same High court in Madras has taken a different view in the case of **National Company v. ACIT[8],** wherein they held that immovable property distributed to retiring partner would not come within the ambit of Section 45(4) of the Act. Thus there is no capital gains because consideration is being paid to partners in lieu of their interest in the firm. This view is contract to A.N. Naik case (supra). They had relied upon some of the Supreme court judgements which were based on the erstwhile provision of the Act before the amendment. Thus decision of Madras High court has restarted the entire controversy but it is yet to be seenwhether this decision would stand the etst of the time.

It is pertinent to note that the erstwhile provisions had a specific provision in the form of Section 47(ii) stating that allocation of capital assets in case of dissolution of partnership wouldnot be a transfer. Thus, it would be out of the ambit of capital gains tax. Section 45(3) and Section 45(4) was introduced as a result of this.

In the case of ***Sunil Sidharthbhai[9]***, it was held by the Supreme court that capital gains tax is not leviable in case a partner at the time of his admission contributes his personal assets into the firm's asset. Due to the above judgement, certain taxpayers started misusing the law to avoid the payment of capital gains tax to the government. The government introduced Section45(3) which stated that any contribution in the form of capital assets made by a partner is subject to tax.

[6] (2004) 265 ITR 346 (Bom)

[7] TCA NO. 1458 of 2005.

[8]TCA. No. 365 & 366 of 2009 dated April 08, 2019

[9] Sunil Sidharthbhai v. CIT (1985) 156 ITR 509

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It is very common for companies to set up SPV for the purpose of making investments into their parent companies and in such situation this SPV is preferred as a partnership firm because there are tax benefits linked to it. Thus, it becomes very important to have clarity on this subject.

RECENT CHANGES INTRODUCED VIDE FINANCE BILL, 2021

The Finance Act, 2021 introduced a new provision as Section 9B. The aim of the new provision is to tax when a specified person is allotted any capital asset or stock in trade by the specified entity as a result of dissolution or reconstitution. The tax liability falls on the specified entity in the year in which the capital asset or stock in trade is received by the specified person. Thus, Section 9B aims to cover only two instances, namely the reconstitution and dissolution. Further, it is pertinent to note that the previous Section 45(4) dealt only with dissolution and the question of reconstitution was not very clear. However, in the matter of AK Naik & Associates , it was held by the High court of Bombay that Section 45(4) covers retirement under the ambit of "otherwise". Section 9B has now made it clear to that extent. It is important to note that Section 9B does not cover instances where the specified person receives money.

Implications under Section 45(4)

The judgement of AK Naik is in a way implemented to make it clear that this new sub section covers reconstitution. The capital asset or money received by the specified person as a result of reconstitution of specified entity is taxable under this provision in the hands of the specified entity. The specified entity has to pay tax on the difference of amount lying in the capital account at the time of reconstitution and fair market value of the capital asset and money at the time of reconstitution. It is pertinent to note that the money which is paid on dissolution is not covered within the ambit of either Section 9B or Section 45(4).

Upon reading the new section, it is clear that the tax is to be paid by specified entity on the amount being paid in excess to the capital account balance. Hence, this new section is trying to tax the excess amount over the balance in the capital account of the specified person. A question for consideration here is, what exactly is the specified entity transferring/extinguishing to the specified person so as to come under the obligation to pay taxand that too under the head of

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"capital gains". It is pertinent to note that the specified person isideally transferring his rights in favour of the continuing partners. Has the legislature placed the taxation event wrongly under the head 'capital gains'. There is no clarity on this part.

Certain other issues arising from interpretation of Section 45(4) is it's applicability. The gains arising after distribution of capital asset or stock in trade to the partner would be deemed to be the income of specified entity. The major objective of Section 45(4) is to levy tax on the excess amount lying to the credit of the capital account balance of the retiring partner.

Further, it is important to note that the term 'money' is not defined in the Act. The provision states that "*if any person receives any money or capital asset or both".* Thus, there arises a possibility of different interpretation of the term 'money'. One interpretation can be that money would mean to include not only cash but readily convertible assets as well such as stock in trade and other similar assets. On the other hand, the other interpretation can be that since money was specifically spelt out in the provision, all other kind of assets are not to be includedspecially when section 9B specifically deals with stock in trade.

Since the section does not specifically include any other kind of liquid asset, only money in the form of cash would be taxed in the hands of the firm.

For the purpose of Section 45(4), there is ambiguity with respect to period of holding of capital asset that is should the period of holding be considered from the time capital was brought in by the partner in the firm or should be the date from which the person became the partner in the firm. Classification of capital asset as long term or short term is important to determine the tax rate and this classification would depend upon the period of holding. There is not much guidance on the same thus it is not possible to determine the amount.

Section 45(4) covers cases of reconstitution only and this can become a cause of litigation further since it is not expressly mentioned. This issue may have large implications. Section 45(4) would be inapplicable in case a partner receives stock in trade. Further, self-generated goodwill is excluded while computing the balance in the capital account of the retiring partner.

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CONCLUSION

The changes brought by Finance Act in the year 2021 will resolve certain issues which were a subject of litigation in the past. Some issues have been resolved to a great extent. Having said that, there are still certain open issues left that needs much needed clarity.

With respect to Issue 1, as far as the amounts received by the partner are not in excess of the credit lying in their capital accounts, there would not arise any tax implications. Tax implications will only arise where there is a lumpsum payment or when there is a payment of excess amount. BY making an amendment and replacing the earlier sub-section, the legislative intent is clear. Thus, judgements like Mohanbhai Pamabhai still holds good today since there is no amendment made to get the amounts received on retirement. Accordingly, tax is to be paid by the specified entity even in cases of retirement of partner since that falls within the ambit of reconstitution. The aspect which is remaining to be addressed is tax implication on allotment of money at the time of dissolution as the same is not covered either under section 9B or Section 45(4).

With respect to Issue 2, ideally the tax implications should not depend upon the type of consideration being received by the retiring partner. Thus, irrespective of the fact that whether the partner has received capital asset or money, taxation should be same. However, as mentioned above, the Bombay High court in AK Naik case, held that allocation of capital asset would be taxable in the hands of the firm under Section 45(4) since the term “otherwise” covers retirement and the same has to be read with “transfer”. The above decision lays down a good proposition and post amendment there has been clarity as the legislature has clearly mentioned the tax implications in case of transfer of capital asset.

With respect to third issue, the Supreme court in Sunil Siddharathbhai stated that there exists a transfer when a personal asset is being contributed to the firm because the contributing partner loses their exclusive right in the property, which they earlier had. However, it was stated by the Supreme court that the amount recorded in the book firms may not represent the correct value of consideration. Thus, the legislature introduced Section 45(3) stating that the said transaction would be considered as transfer and consideration would be the amount being recorded in the firm’s books.